

Designing derivatives CCP reforms¹

Remarks by
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Thank you for the kind introduction. Good morning, everyone.

Now that Ranjit has laid out an excellent overview of the global regulatory reform efforts, let me focus on several specific questions in the derivatives CCP reforms. I hope my remarks could work as a bridge to the next session, which is titled "Clearing the World."

The derivatives market reform agenda set by the G20 leaders in 2009 will be largely addressed when the new margin requirements for non-cleared derivatives is implemented in September. There are remaining issues, including bilateral process for mutual recognition and substituted compliance, but we may say that we are transiting from the designing phase to the implementation phase of the reform.

But one major design agenda remains, which aims at improvements in the resilience, recovery planning and resolution of CCPs.

The agenda is pursued by multiple groups of regulators: CPMI-IOSCO is working on resilience and recovery, and a sub-group of the FSB is addressing resolution issues. In the adjacent areas, the BCBS and IOSCO is responsible for the margin requirements for non-cleared transactions, and the BCBS is in charge of capital requirements on exposure to CCPs and on derivatives positions.

If we are to optimize the aggregate effects of the reforms, we need to secure that elements of the reform best complement with each other. We should design the overall reform taking into account trade-offs which exist between resilience of CCPs, CCPs' need to balance the interests of various stakeholders, incentives for central clearing, and incentives for better risk management.

And perhaps the most important task is to understand the mechanism how CCPs contribute to financial stability. Let me start with this.

¹ The speaker borrowed many ideas from Atsushi Miyauchi, *Kin-yuu kiki to Basel kisei no Keizai gaku* (*The Economics of the Financial Crisis and Basel Frameworks*), Keiso Shobo, 2015. Views expressed are the speaker's, not necessarily of the Financial Services Agency.

During the last global financial crisis, the non-cleared markets contributed to the propagation of the crisis, while centrally cleared markets proved resilient and continued to function. I understand that this was because CCPs reduced three types of risks: the risk of domino effects, the risk of runs, and the risk of fire sales.

Domino effects

CCPs reduce the risk of domino effects due to the following three reasons.

Firstly, a CCP reduces the amount of the exposure to a failing counterparty by making multilateral netting possible.

Secondly, at the time of the last crisis, CCPs had more rigorous margin requirements than many parties to bilateral trades. CCPs were able to cover the losses arising from the failure of Lehman Brothers with the margin posted by it.

This difference will be reduced when non-cleared derivatives come under the new margin requirements, but the difference will not disappear, as initial margin below 50 million euros is exempted with regard to non-cleared transactions.

Thirdly, a CCP may be able to stop domino by loss mutualization even if the losses arising from the failure of a counterparty exceed the margin posted by it.

Loss-mutualization will spread the shock to clearing members. If the losses exceed the pre-defined loss-allocation capacity, the CCP may fail, and given the critical functions it plays, the impact could be enormous. The impact, however, may be mitigated to some extent by a good resolution planning.

Although a CCP might not be a panacea, on balance a system where derivatives transactions are centrally cleared should have a less propensity to domino effects.

Runs

Second, CCPs reduce the risk of runs.

Many counterparties to Lehman Brothers in non-cleared derivatives transactions did not demand necessary margins to be posted in good times. When the doubts on the solvency of Lehman mounted, however, they suddenly requested additional margins and novation. This market driven run on Lehman depleted the last remaining liquidity of the failing house.

Such run did not occur with regard to centrally cleared transactions. As CCPs had more rigorous margin requirements, they did not have to resort to last minute requests. In addition, as CCPs replace the counterparty risk, other parties do not feel the need to run so far as CCPs are believed to be resilient.

A centrally cleared market will be less susceptible to runs so far as CCPs manage

their risks better and stay resilient.

Fire sales

Third, CCPs can reduce the risk of fire sales.

After Lehman collapsed, counterparties to it rushed to cover the resultant open positions, a behavior akin to fire sales. CCPs also had to cover their positions with Lehman, but they could resort to auction with their clearing members and returned to matched books in a more orderly manner. Larger fire sales should happen, however, if a CCP runs out of its waterfall and tear up their obligations.

A centrally cleared market will be less susceptible to fire sales so far as CCPs have better default management processes and stay resilient.

Shock amplification through CCPs?

I have described three channels through which CCPs can contribute to financial stability.

Some, however, argue that CCPs can buffer the system against relatively small shocks, at the risk of potentially amplifying larger ones.² Indeed, some of the benefits I have described would disappear if a CCP fails, but other benefits will remain. A CCP failure would be systemic and highly detrimental, but this does not necessarily mean that a CCP amplify the shocks. The shock which can cause a CCP to fail should be bigger than that of simultaneous disorderly resolutions of two G-SIBs and should cause major domino effects even if derivatives markets are dominated by bilateral transactions.

Whether the CCPs will increase or decrease the domino effects under such extreme scenarios will depend on the specific conditions of interdependencies between CCPs and their members. I hope that the work to be conducted by the Study Group on Central Clearing Interdependencies, which was jointly established by four standard setters, will shed some light on this issue.

Consequences of regulation

We have seen how central clearing can reduce the risk of domino effects, runs and fire sales. Then the next question would be how we can maximize the benefits.

Where incentives of clearing members and CCPs are not fully aligned to the goal of financial stability, there may be a room for regulation to contribute to the enhanced benefit. On the other hand, regulations aiming to attain certain

² See, for example, Domanski, Gambacorta and Picillo, "Central clearing: trend and current issues," *BIS Quarterly Review*, December 2015

outcomes can generate unintended consequences by changing incentives and affecting market participants' behavior. We need to be attentive to both possibilities.

Role for regulatory oversight

There is a role regulators can play in maximizing financial stability benefits of the use of CCPs.

For example, competition between CCPs may create an incentive for CCPs to adopt less rigorous modeling of potential future exposures. However, risk modeling, particularly that of wrong way risks or of market liquidity, has to be continuously improved, since a significant part of CCPs' contribution to reduced risk of dominos, runs and fire sales comes from their good risk management practices.

Also, by having a lenient margin requirement in peace time, a CCP can attract more business, but if it does so, it will have to tighten the requirement in time of market stress, and can thereby amplify the stress. Margin models should not be overly pro-cyclical.

A CCP may not have a strong incentive to plan for their recovery from an extreme events. But a resolution plan which articulates who bear the costs in a tail event will provide CCPs and clearing members with incentives to monitor and control risks more carefully. CCPs should be encouraged to produce thorough recovery plans.

These examples would suggest that there are important roles the Principles for Financial Market Infrastructures, or PFMI.

ABCDEFG

On the other hand, regulations aiming at certain outcomes do not necessarily attain them: Unintended consequences may arise due to altered incentives and behavior on the part of market participants.

Last week, Commissioner of the Japan FSA, Nobuchika Mori, argued that the effects of regulatory reforms should be assessed from the perspectives from A to G: A for aggregate effects of multiple regulations, B for behavioral changes of market participants, C for cross-sectoral impacts such as the impacts of prudential regulations would have on market liquidity, D for dynamic effects of regulatory changes over coming periods, E for ecosystem perspectives, or paying attention to mutual dependencies among players in the market, and G for general equilibrium analysis which pays attention to interactions and interdependencies existing in the system.³

³ Nobuchika Mori, "From static regulation to dynamic supervision," Keynote speech at

For example, less liquid products are susceptible to market disruptions and will benefit from being centrally cleared. If we require less liquid derivatives transactions to be centrally cleared, however, default management will become more challenging. The need for prudent margin requirements and loss-sharing arrangements may become greater.

Strong margin requirements will enhance the resilience of CCPs and reduce the risk of loss mutualization, but will also make centrally cleared transactions less attractive to market participants, who then may resort to similar but different non-cleared products.

It is argued that prudential regulations, such as leverage ratio requirements, have resulted in withdrawals from clearing membership and customer clearing. Increased risk of loss mutualization and increased margin requirements may further accelerate the trend.

If clearing membership becomes more concentrated, the cover-one and cover-two standards will become more onerous. If more banks withdraw from customer clearing, market liquidity may be affected. The withdrawals may also have the effect of making the survivor banks “too un-substitutable to fail.”

Extinction of certain species of planktons may affect the whole ecosystem of the lake. Banks providing customer clearing services may be to the derivatives market what planktons is to the lake.

On the other hand, it may also be said that if more banks join a CCP, diversity in clearing membership will increase and agreeing on loss mutualization may become more difficult.

I am not arguing that the above considerations should make us design the reform in one way or the other, but that our choices have to be properly informed by such considerations as above.

Conclusion

In concluding my remark, let me summarize what I wanted to say today. There are benefits to be gained by CCP reforms, but, at the same time, in order to well attain the benefits, a careful balancing act is needed. A CCP is a private entity which depends on a delicate balance of incentives given to members and owners for its sustainable functioning. At the same time, it plays a highly public role and has significant externalities. We need to design regulatory principles with this dual properties in mind.

Thank you.